IMAGE SENSING SYSTEMS INC
Form 10QSB
November 09, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended September 30, 2005

[_] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT For the transition period from _________ to _________

Commission file number: 0-26056

IMAGE SENSING SYSTEMS, INC.
(Exact name of small business issuer as specified in its charter)

Minnesota	41-1519168
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 SPRUCE TREE CENTRE
1600 UNIVERSITY AVE. W.
ST. PAUL, MN 55104-3825
(Address of principal executive offices)

(651) 603-7700
(Issuer's telephone number)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes [X] No [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes [ ] No [X]

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practical date: Common Stock, $.01 par value, 3,664,054 shares as of October 24, 2005.

Transitional Small Business Disclosure Format: Yes [ ] No [X]

IMAGE SENSING SYSTEMS, INC.

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PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30 2005 (Unaudited)
ASSETS	
Current assets:	
Cash and cash equivalents	$ 5,902,000
Short-term investments	1,750,000
Accounts receivable	3,627,000
Inventories	450,000
Investment in FHLB bond	2,300,000
Prepaid expenses	132,000
Deferred income taxes	49,000

Total current assets	14,210,000
Property and equipment, net	244,000
Other assets:	
Capitalized software development costs, net	226,000
Goodwill	1,050,000
	1,276,000
Total assets	$ 15,730,000
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$ 382,000
Accrued compensation	407,000
Income taxes payable	379,000
Total current liabilites	1,168,000
Deferred income taxes	144,000
Shareholders' equity:	
Common stock	37,000
Additional paid-in capital	7,027,000
Retained earnings	7,354,000
	14,418,000
Total liabilities and shareholders' equity	$ 15,730,000

Note: The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

See accompanying notes

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IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three-Month Periods Ended September 30		Nine-Month Peri September
	2005	2004	2005

REVENUE:				
Royalty income	$ 2,669,000	$ 2,511,000	$ 6,468,000	$
International sales	794,000	566,000	1,646,000	
	3,463,000	3,077,000	8,114,000	
COSTS OF REVENUE:				
Cost of product sold	322,000	219,000	653,000	
Royalty fee	118,000	102,000	288,000	
	440,000	321,000	941,000	
Gross profit	3,023,000	2,756,000	7,173,000	
OPERATING EXPENSES:				
Selling, marketing and product support	480,000	565,000	1,805,000	
General and administrative	365,000	369,000	1,071,000	
Research and development	523,000	331,000	1,151,000	
	1,368,000	1,265,000	4,027,000	
Income from operations	1,655,000	1,491,000	3,146,000	
Other income, net	66,000	21,000	172,000	
Income before income taxes	1,721,000	1,512,000	3,318,000	
Income taxes	576,000	535,000	1,166,000	
Net income	$ 1,145,000	$ 977,000	$ 2,152,000	$
Net income per common share:				
Basic	$ 0.32	$ 0.28	$ 0.60	$
Diluted	$ 0.30	$ 0.26	$ 0.56	$
Weighted average number of common shares outstanding:				
Basic	3,625,000	3,442,000	3,576,000	
Diluted	3,851,000	3,818,000	3,865,000	

See accompanying notes

IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine-
	2005
OPERATING ACTIVITIES:	
Net income	$ 2,152,000
Adjustments to reconcile net income to net cash provided by operating activities	
Depreciation and amortization	275,000
Change in operating assets and liabilities	(1,276,000)
Net cash provided by operating activities	1,151,000
INVESTING ACTIVITIES:	
Purchase of property and equipment	(199,000)
Sale (purchase) of short-term investments	3,250,000
Purchase of callable FHLB bond	-
Net cash provided by (used in) investing activities	3,051,000
FINANCING ACTIVITIES:	
Proceeds from exercise of stock options	438,000
Net cash provided by financing activities	438,000
Increase in cash and cash equivalents	4,640,000
Cash and cash equivalents, beginning of period	1,262,000
Cash and cash equivalents, end of period	$ 5,902,000

See accompanying notes

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IMAGE SENSING SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2005

Note A: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the financial statements and footnotes thereto in our Annual Report on Form 10-KSB for the year ended December 31, 2004.

Note B: Investments

Investments, at cost, consisted of the following at September 30, 2005 and December 31, 2004:

	September 30, 2005	December 31, 2004
Short-term investments - Auction Rate Securities	$1,750,000	$5,000,000
Callable Federal Home Loan Bonds	2,300,000	2,300,000
Total	$4,050,000	$7,300,000

As of September 30, 2005 and December 31, 2004, investments are classified as available-for-sale. The cost of investments approximate market value and therefore no amount is recorded in accumulated other comprehensive income. The cost of securities sold is based on the specific identification method.

Proceeds from maturities and sales of investments totaled $3,250,000 for the nine-month period ended September 30, 2005. There were no sales or maturities in 2004. There were no realized gains or losses related to sales or unrealized gains and losses during the nine-month periods ended September 30, 2005 and 2004.

Note C: Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share for the three-and nine-month periods ended September 30, 2005 and 2004:

Three-Month Periods Ended September 30,		Nine-M Ended
2005	2004	2005

Numerator:			
Net income	$1,145,000	$977,000	$2,152,000
Denominator:			
Shares used in basic income per share calculation	3,625,000	3,442,000	3,576,000
Effect of diluted securities:			
Employee and director stock options	226,000	376,000	289,000
Shares used in diluted earnings per share calculations	3,851,000	3,818,000	3,865,000
Basic earnings per share	$.32	$.28	$.60
Diluted earnings per share	$.30	$.26	$.56

Note D: Stock Options

Stock options issued to employees are accounted for under the intrinsic value method as prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees." No stock-based employee compensation cost is reflected in net income, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and net income per share if we had applied the fair value method of accounting for stock options under the provisions of Financial Accounting Standards Board (FASB) Statement No. 123, "Accounting for Stock-Based Compensation" (in thousands, except per share amounts):

	Three-Month Periods Ended September 30,		Nine-M Ended
	2005	2004	2005
Net income, as reported	$1,145	$977	$2,152
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	51	55	160
Pro-forma net income	$1,094	$922	$1,992
Net income per share:			
Basic - as reported	$.32	$.28	$.60
Basic - pro forma	$.30	$.27	$.56
Diluted - as reported	$.30	$.26	$.56
Diluted - pro forma	$.28	$.24	$.52

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for all periods presented: zero dividend yield; expected volatility of 127; risk-free interest rate of 4.27% and expected life of 10 years.

In December 2004, the FASB issued Statement of Financial Accounting Standards Statement No. 123 (revised 2004), "Share-Based Payment." This statement is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." This statement is effective in the first annual period that begins after December 15, 2005. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and requires that the compensation cost relating to share-based payment transactions be measured on the fair value of the equity or liability instruments issued. The Company will adopt this statement effective January 1, 2006. The effects of adoption on the financial statements have not been determined, but are not expected to differ materially from the pro-forma effects disclosed above.

Item 2. Management's Discussion and Analysis or Plan of Operation

Overview:

We have developed proprietary machine vision technology that converts real world information into digital electronic signals for processing by computer and have applied it to traffic management problems. Our technology uses standard video and computer equipment, combined with proprietary technology, including complex detection algorithms, computer software, special purpose hardware, and a Microsoft Windows(R)-based graphical user interface that enables standard video cameras to work with the Autoscope(R) Wide Area Video Vehicle Detection System.

Autoscope systems are sold to distributors and end users of traffic management products in North America and Latin America by Econolite Control Products, Inc. (Econolite), our licensed distributor in those locations. We also sell Autoscope systems to distributors and end users in Europe and Asia through our European and Hong Kong subsidiaries, respectively. The Autoscope system is used by traffic managers primarily to improve the flow of vehicle traffic and to enhance safety at intersections, main thoroughfares, freeways and tunnels. Flow Traffic Ltd., our Asian subsidiary, also sells loop detection products in Asia.

The majority of our revenue is derived from royalties received from Econolite, with a second primary source of revenue produced from direct international sales in Europe and Asia. End users of the Autoscope system throughout the world are generally funded by government agencies responsible for traffic management and/or traffic law enforcement.

Our success is primarily dependent upon (1) continued governmental funding of "Intelligent Transportation Systems", such as machine vision for traffic control; (2) our ability, through Econolite and our sales representatives in Europe and Asia, to successfully market the Autoscope System to individual traffic managers and (3) our ability to develop new machine vision products

and applications that enhance the traffic manager's ability to cost-effectively improve traffic flow and safety.

Results of Operations: (Comparison of three-and nine-month periods ended September 30, 2005 and 2004)

The following table sets forth for the periods indicated (1) certain statements of income data as a percent of total revenue and (2) gross profit on royalty income and international sales as a percentage of royalty income and international sales, respectively, shown in italics:

	Three-Month Periods Ended September 30		Nine-Month Periods Ended September 30	
	2005	2004	2005	200
Royalty income	71.1 %	81.6 %	79.7 %	66.
International sales	22.9	18.4	20.3	33.
Total revenue	100.0	100.0	100.0	100.
GROSS PROFIT - ROYALTY INCOME	95.6	95.9	95.5	95.
GROSS PROFIT -INTERNATIONAL SALES	59.4	61.3	60.3	50.
Operating expenses	39.5	41.1	49.6	41.
Income from operations	47.8	48.4	38.8	39.
Income taxes	16.6	17.4	14.4	13.
Net income	33.1	31.8	26.6	26.

Revenues for the third quarter of 2005 were $3,463,000, an increase of 12.5% from $3,077,000 for the same period a year ago. Royalty income for the third quarter of 2005 was $2,669,000, an increase of 6.3% from $2,511,000 for the comparable period in 2004, indicating continued acceptance of our products in the North American market. International sales revenues for the third quarter of 2005 were $794,000, an increase of 40.3% from $566,000 for the comparable period in 2004 primarily due to increased sales volume in both Europe and Asia.

Revenues for the nine-month period ended September 30, 2005, were $8,114,000, a decrease of 5.4% from $8,578,000 a year ago. Royalty income for the nine-month period ended September 30, 2005 was $6,468,000, an increase of 13.5% from $5,698,000 for the comparable period in 2004 reflecting Econolite's continued success in the North American market. International sales for the nine-month period ended September 30, 2005 were $1,646,000, a decrease of 42.8% from $2,880,000 for the comparable period in 2004 due primarily to reduced sales of Autoscope and loop detector products in the Asian market. The decrease in revenues for the nine-month period was due entirely to a decrease in sales by our Hong Kong subsidiary, Flow Traffic Ltd. Flow Traffic was unable to repeat a large Autoscope sale in Korea that it experienced in the second quarter of 2004. In addition, transition to a new loop detector product for sale in the Asian market was delayed due to technical issues that have since been corrected.

Competition in the Asian market for machine vision products in the traffic management industry is increasing and has adversely affected our ability to sell Autoscope products there. We believe that by improving the functionality of our Autoscope products we will be able to compete more effectively in the future. In addition, the transition to a new loop detector product for the Asian market has been delayed, as the first software release for the product lacked certain features which appear to have adversely affected sales of the product. We have added functionality to the loop detector software and have successfully tested the new version. We are cautiously optimistic that sales of the loop product will occur in the latter part of the fourth quarter.

Gross profits on royalty income for the three- and nine-month periods ended September 30, 2005 were $3,023,000 and $7,173,000, respectively, compared to $2,756,000 and $6,920,000, respectively, for the same periods of 2004. The increase in the third quarter of 2005 reflects the increases in both royalty income and international sales over the comparable period in 2004, while the increase in the nine-month period of 2005 was due to increased royalty income which more than offset a decrease in gross profit from reduced international sales. Gross profit margins on royalty income has remained relatively unchanged, while margins on international sales were 59.4% and 60.3% for the three- and nine-month periods of 2005, respectively, compared to 61.3% and 50.9% for the comparable periods in 2004. The decrease in gross profit margins in the third quarter was due primarily to the mix of products sold, with relatively higher sales of a lower margin product in 2005 compared to 2004. The increase in margins for the nine-month period of 2005 over 2004 was due primarily to the one-time sale in the first quarter of 2004 of low-margin cameras. Gross profit margins on our primary Autoscope products continue to hold steady and have increased in Europe in areas where we sell direct to the end user rather than to a distributor.

Operating expenses were $1,368,000 and $4,027,000, respectively, for the three- and nine-month periods ended September 30, 2005, or 39.5% and 49.6% of revenue, compared to $1,265,000 and $3,527,000, or 41.1% of revenue for the same periods in 2004. Selling, marketing and product support expenses decreased for the third quarter of 2005 due primarily to more engineering time allocated to research and development and away from product support while increasing for the nine-month period of 2005 due to higher payroll and travel costs related to added sales and support staff in Europe and the United States. General and administrative expenses decreased marginally in the third quarter of 2005 and increased during the nine-month period of 2005 due primarily to added performance bonuses, insurance expense and legal and audit fees incurred in the first-half of the year. Research and development expenses increased for the three- and nine-month periods ended September 30, 2005 due to additional engineering staff allocating time to new product development and more use of outside consultants as part of product development. We expect that our operating expenses will continue to increase during the remainder of 2005, compared to 2004, to cover additional sales and product support hires in Europe and engineering staff in the United States.

Income from operations in the third quarter of 2005 was $1,655,000, or 47.8% of revenue, compared to $1,491,000, or 48.4% of revenue, in the comparable quarter in 2004. Income from operations for the nine-month period ended September 30, 2005 was $3,146,000, or 38.8% of revenue, compared to $3,393,000, or 39.6% of revenue, in the comparable period in 2004. The increase in income from operations for the third quarter of 2005 was due primarily from increased revenue in the quarter while the decrease in the nine-month period was due to decreases in international sales by Flow Traffic Ltd. in the first half of 2005 and increases in all three categories of operating expense.

Income taxes were $576,000, or 33.5% of pretax income, in the third quarter of

2005, compared to $535,000, or 35.4% of pretax income, in the comparable quarter of 2004, while income taxes were $1,166,000, or 35.1% of pretax income, in the nine-month period ended September 30, 2005, compared to $1,162,000, or 33.8% of pretax income in the comparable period of 2004. The increase in income taxes in the third quarter of 2005 was due primarily to having more taxable income than the comparable quarter of 2004 while the increase for the nine-month period of 2005 compared to 2004 was primarily due to the inability to offset losses in Asia against prior year taxable income. We expect income taxes to remain at approximately 33-35% of pretax income for the remainder of the year.

Net income was $1,145,000, or 33.1% of revenue, in the third quarter of 2005, compared to $977,000, or 31.8% of revenue, in the comparable quarter of 2004. Net income was $2,152,000, or 26.5% of revenue, in the nine-month period ended September 30, 2005, compared to $2,276,000, or 26.5% of revenue in the comparable period in 2004. The change in net income and net income as a percent of revenue is due to the factors discussed above.

Liquidity and Capital Resources:

At September 30, 2005, we had $5,902,000 in cash and cash equivalents, compared to $1,262,000 at December 31, 2004. Included in cash equivalents at September 30, 2005 was $4,855,000 in a tax-exempt money market fund. The increase of $4,640,000 in cash and cash equivalents at September 30, 2005 compared to December 31, 2004 was due primarily to the sale of short-term investments during the second and third quarters of 2005 and from cash provided by operating activities in the first nine months of 2005. Net cash provided by operating activities was $1,151,000 in the nine-month period ended September 30, 2005, compared to $1,889,000 in the comparable period of 2004. The decrease was due primarily to accounts receivable increasing more in the first nine-months of 2005 compared to 2004.

We had working capital of $13,042,000, and a ratio of current assets to current liabilities of 12.2 to 1 at September 30, 2005, compared to $10,326,000 and 10.1 to 1, respectively, at the end of 2004.

We are accumulating cash in order to obtain the liquidity needed to take advantage of acquisition opportunities that may become available and to allow continued investment in product development and expansion of our market reach in Asian and European. We continue to meet with other businesses in the United States and Europe that manufacture, sell or distribute other traffic management products that fit with our long-term strategy of growing world-wide in the intelligent transportation market. We also are investigating manufacturing alternatives outside of the United States with the objectives of lowering our cost of manufacturing and becoming compliant with the new hazardous content and disposal regulations which become effective in European Union countries as of July 1, 2006.

We have a credit agreement with Wells Fargo Bank, N. A. that provides up to $1,000,000 in short-term borrowings at .5% over the prime rate (effective rate of 7.25% at September 30, 2005). Loans under this agreement would be secured by receivables, inventories, equipment and general intangibles. We had no outstanding borrowings under the credit agreement in 2005 or 2004.

We believe that cash and cash equivalents and short-term investments at September 30, 2005, our $1,000,000 revolving line of credit and cash provided by operating activities will satisfy our projected working capital needs, investing activities and other cash requirements in the foreseeable future.

Off-Balance Sheet Arrangements:

We have no off-balance sheet arrangements.

Cautionary Statement:

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES
LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-QSB contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange of 1934, as amended. Forward-looking statements represent our expectations or beliefs concerning future events and can be identified by the use of forward-looking words such as "expects," "believes," "may," "will," "should," "intends," "plans," "estimates," or "anticipates" or other comparable terminology. Forward-looking statements are subject to risks and uncertainties that may cause our actual results to differ materially from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to:

- dependence on a single product for most of our revenue;
- budget constraints by governmental entities that purchase our products;
- continuing ability of our licensee to pay royalties owed;
- dependence on third parties for manufacturing and marketing our products;
- dependence on single-source suppliers to meet manufacturing needs;
- failure to secure adequate protection for our intellectual property rights;
- our inability to develop new applications and product enhancements;
- our inability to properly manage a growth in revenue and/or production requirements;
- control of our voting stock by insiders;
- our inability to retain key scientific and technical personnel;
- volatility of our stock price;

- our inability to achieve and maintain effective internal controls;
- our inability to comply with international regulatory restrictions over hazardous substances and electronic waste; and
- conditions beyond our control such as war, terrorist attacks, health epidemics and economic recession.

We caution that the forward-looking statements made in this report or in other announcements made by us are further qualified by the risk factors set forth in Item 1 of our Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004.

Item 3. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

During the fiscal quarter covered by this report, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 6. Exhibits

The following exhibits are filed as part of this quarterly report on Form 10-QSB for the quarterly period ended September 30, 2005.

Exhibit Number	Description
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Image Sensing Systems, Inc.

By:

Dated: November 9, 2005 /s/ James Murdakes

James Murdakes
Chairman and Chief Executive Officer
(principal executive officer)

Dated: November 9, 2005 /s/ Arthur J. Bourgeois

Arthur J. Bourgeois
Chief Financial Officer
(principal financial and accounting officer)

EXHIBIT INDEX TO FORM 10-QSB

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31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Chief Executive Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated November 9, 2005.
32.2	Chief Financial Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated November 9, 2005.